



24 April 2006

**Enterprise Risk Management in 2006:  
“Leaving Insurance Land”**

**John C.R. Hele, FSA, FCIA, MAAA  
Deputy CFO, ING Group**

**Content**

---

- **Introduction**
- **“Insurance Land” Myths**
- **Moving to Reality**

## “Insurance Land”... some examples of old thinking

*“Of course you know,  
the value of an insurance liability  
today depends  
upon the assets backing that liability”*

*“Don’t compare us to a Bank!  
Insurance and Banks are completely different  
animals that cannot and  
are not compared by investors”*



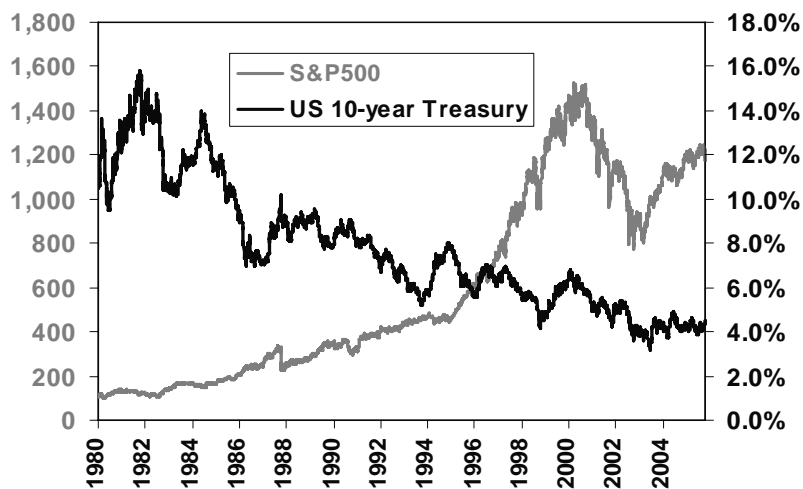
*“Always value your liabilities  
under the assumption that assets  
backing the liabilities are invested  
under a ‘buy and hold’ strategy”*

*“Pricing does not need to consistent with the capital  
markets today – don’t you know,  
you have to view from a long term perspective”*

**But is all this conventional wisdom still applicable in 2006?**

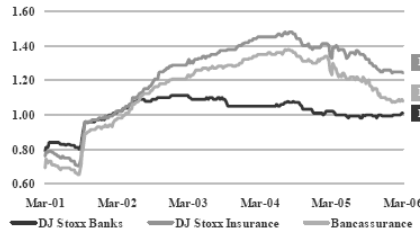
## What has changed?

### The Bull Market is Over

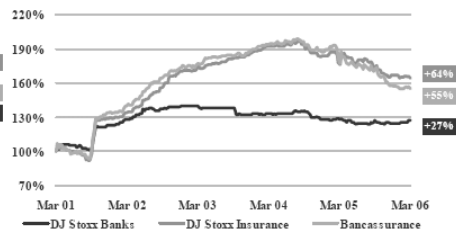


## European Insurers are considered riskier than European banks

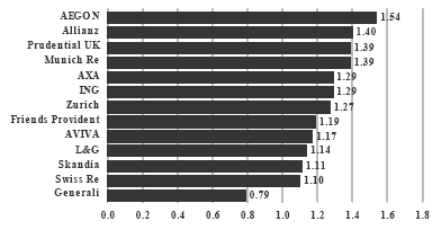
Beta of European Insurers, Banks and Bancassurers <sup>(1)</sup>



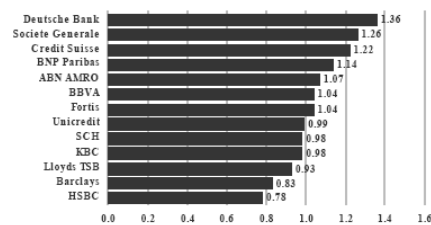
Re-Based European Insurance Betas



Selected European Insurers' Beta Ranking



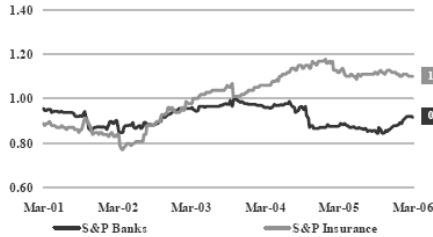
Selected European Banks Beta Ranking



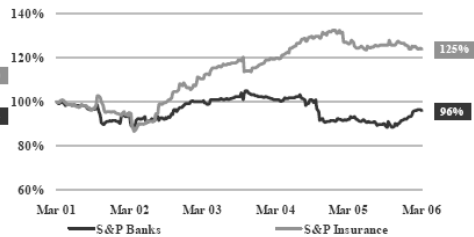
Note: All betas are 2-year adjusted (weekly) calculated against the Dow Jones Stoxx Europe (600) index.  
 1. Bancassurance: Allianz, Fortis, ING, Lloyds TSB and KBC.  
 Source: Lehman Brothers

## US insurers have higher betas than US banks

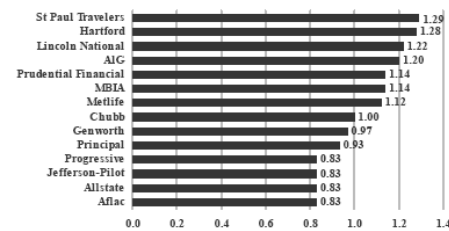
Beta of US Insurers and Banks



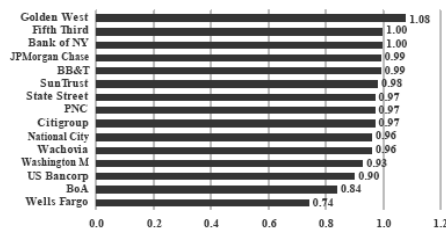
Re-Based US Insurance and Banks Betas



Selected US Insurers Beta Ranking



Selected US Banks Beta Ranking



Note: All betas are 2-year adjusted (weekly) calculated against the S&P 500 index.  
 Source: Lehman Brothers

## US GAAP & IASB → Fair value: The ball is already in motion...

---

*"The FASB has previously stated its long-term objective of establishing standards that would **require reporting all financial instruments at fair value** in the financial statements, provided certain conceptual and practical issues relating to measurements and display can be satisfactorily resolved. The Board currently has a number of projects on its agenda directed toward that objective, including its project on **Fair Value Measurements that addresses conceptual and practical issues relating to measurement**, a project on *Financial Instruments: Liabilities and Equity*, and a project on *Financial Performance Reporting by Business Enterprises*."*

– FASB response to SEC 16/2/2006

*"Some, including **professional investors, financial analysts, and accounting standard setters see fair value accounting as a way to simplify accounting standards and to improve the relevance and transparency of financial statements**. However, many others oppose the use of fair value accounting, viewing it as introducing unacceptable subjectivity and misleading volatility into reported results."*

– FASB response to SEC 16/2/2006

## Risk Managers will have to leave "Insurance Land"...

---

**...And enter Financial Services Land**

**– otherwise known as REALITY**

## Content

- Introduction
- “Insurance Land” Myths
- Moving to Reality

## Liability measurement

### *“Insurance Land” thinking*

- The value of an insurance liability today depends upon the assets backing that liability

### *Financial Services Reality*

- “In the IASB Board’s view, the cash flows from an asset are irrelevant for the measurement of a liability”, IFRS 4 Basis for Conclusions
- IFRS 37: 37 “the best estimate of the expenditure required to settle the present value of the obligation is the amount that an entity would RATIONALLY pay to settle the obligation...or transfer it to a third party”

## Liability sale / acceptance

### *"Insurance Land" thinking*

- There is a view that Fair Value or Market Value Liabilities for insurance overstate reality as buyers are willing to accept insurance liabilities at a rate less than those valued by swap curve
- Or the counter view that one cannot calculate a market value for liabilities



### *Financial Services Reality*

- IFRS 37:S47 " the discount rate(s) shall be a pre-tax rate that reflects current market assessments.. [and ] shall not reflect risks for which future cash flow estimates have been adjusted."
- Sellers and buyers get to a market value, so why only know this when a company or business is sold?

## Asset strategy

### *"Insurance Land" thinking*

- Liabilities are valued under the assumption that assets backing the liabilities are invested under a "buy and hold" strategy



### *Financial Services Reality*

- Assets are generally traded and rarely held to maturity on most products
- Performance of these assets needs to be separated from performance of insurance of a product
- Asset performance is under the responsibility of the investment manager rather than insurance product

## Pricing – At Issue

### *“Insurance Land” thinking*

- Pricing is calculated at issue and reflects all future assumptions
- Reflected in the concept of VNB
- Guarantees are not priced consistent with the capital markets



### *Financial Services Reality*

- The resulting embedded values over the past decade have rarely reflected the initial VNB calculated by the actuary
- Projections from 1, 2, 5, 10 and 20 years ago are off by a material magnitude
- The standard deviation of the mean of assumptions is dramatic, and should be taken into account in pricing and product design

## Pricing - Assumptions

### *“Insurance Land” thinking*

- Based on future views of the actuary, pricing does not need to be consistent with the capital markets today as the actuary is viewing the long term
- Pricing is based historically on the mean without full consideration of tail risk in both assets and liabilities



### *Financial Services Reality*

- In the Morris Review of the UK actuarial profession:  
*“The perceived failure to adopt latest developments in financial economics and financial markets was seen in large part from the role played by entrenched commercial interests...and an insularity that constrained the extent and effectiveness of input from academics, other professions, and those in wider fields of practice.”*

## Disclosure - Investors

### "Insurance Land" thinking

- Insurance and banking are different animals that cannot and are not compared by investors

### Financial Services Reality

- Under an economic view, banking and insurance operations are easily compared by investors
- Investors therefore expect a similar amount and transparency of disclosure from insurers as they are currently receiving from their banking counterparts
- Many banks publish EC, VAR, and EAR with extensive risk and concentration disclosures

## The external environment is adding pressure to move to an EC framework

### Competitors

- European **competitors are already moving towards an EC framework\***
- Leading US firms are also implementing EC frameworks
- Indications are that transaction prices of insurance blocks of business increasingly reflect capital markets pricing of insurance products

### External Stakeholders

- Analysts are placing increasing emphasis on EC and MCEV disclosure
- **Rating agencies are moving to ERM**
- Many generally believe that the **insurance industry is moving towards MCEV**
  - *"MCEV is happening already . . . [and] it will become the norm eventually", Paul Goodhind, Bear Sterns*

### Regulators

- **Many regulators have begun a process to regulate insurance under an Economic framework**
- EU Solvency II, DNB (Dutch regulator), Insurance Group Directive, IAIS, new frameworks in Europe & US
- IAS and Fair Value accounting for both assets and liabilities
- *"Inevitable trend for all companies to move towards EC management, mainly driven by regulators", Paul Goodhind, Bear Sterns*

\* Source: Mercer Oliver Wyman analysis

## Content

- Introduction
- Insurance Land Myths
- Moving to Reality

## What will a Insurance Risk Manager do in Reality?

Dimension	Financial Services Reality
<b>Capital management</b>	<ul style="list-style-type: none"><li>• Capital based on <b>Economic Capital</b> to protect a <b>Market Value of Liabilities (MVL)</b></li><li>• MVLs calculated in a Lego Building Block Approach</li><li>• <b>Active quantification and management of diversification</b></li><li>• <b>Risk Neutral</b></li></ul>
<b>Risk management</b>	<ul style="list-style-type: none"><li>• <b>Creation of Risk Appetite and Risk Limits</b></li><li>• <b>Proactive management of risk limits</b></li><li>• Scenario analysis</li><li>• <b>The ability to break a trade</b></li><li>• Extensive external disclosure: EC, MVL &amp; Risk</li></ul>
<b>Performance measurement</b>	<ul style="list-style-type: none"><li>• Primary performance measures based on Market Consistent Embedded Values – Market Value Balance Sheets</li></ul>
<b>Product management</b>	<ul style="list-style-type: none"><li>• Management of product based on <b>MCEV principles</b></li><li>• <b>Market consistent pricing</b></li></ul>
<b>Accounting</b>	<ul style="list-style-type: none"><li>• Ultimately both <b>assets and liabilities at market value</b></li><li>• <b>Proactive management and/or communication of volatility</b></li></ul>

## Traditional and new metrics come from different worlds

### Traditional view

#### Metrics:

- Value of new business (VNB)

#### Key components:

- Local reserves
- Regulatory/rating agency capital
- Actuary assumptions, esp. discount rate

#### Key rationale:

- Shareholders must earn acceptable return on tied assets ("hurdle rate")

#### Assumption:

- Discount rate appropriately reflect the **overall** risk

### Reality View

#### Metrics:

- ROEV from MCEV

#### Key components:

- Market value of assets and liabilities
- Economic Capital
- Market assumptions, esp. risk free discount rates

#### Key rationale:

- Shareholders must earn acceptable return on **each risk**

#### Assumption:

- Varying costs of capital consistent with individual risk taking

◀ ▶  
Same business,  
different view

## Moving Actuaries to become Risk Managers: which levers do we pull?

"The Actuaries"

### Insurance Risk Management Network

- Re-define roles & responsibilities
- Ensure adequate resources (people/tools)
- Build skill set
- Build high performance culture

"The Business"

### Business Leaders, CFO's, Prod. Mngt.

- Communicate the value added of Risk Management
- Build acceptance and commitment

### Embed Risk Management in core management processes

- Strategy
- Product Development
- Capital Management
- Performance Measurement
- etc.

**The strategic impacts are immense**

**Invest in people**

**Speak a new language**

**Rethink our business  
mix strategy**

**Using a risk management framework will force us to rethink the way we  
understand value creation and manage our business**

**So join us in our journey to view the Insurance Business from a  
market consistent perspective...**



*Current  
"Insurance Land"  
thinking*

*Financial  
Services  
Reality*

